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TORONTO...NOT TO BE RELEASED BEFORE FEBRUARY 20, 1985

DEFICITS: HOW BIG AND HOW BAD? An Ontario Economic Council Position Paper

EXECUTIVE SUMMARY

In March, 1983, the Ontario Economic Council hosted a conference on deficits, with participants from government, business, and university communities airing their views. The conference proceedings, *Deficits: How Big and How Bad?*, have now been published. This present volume, based in part on the conference volume, reflects the Council's own views on the deficit issue. Not all Council members agree with each and every observation, but the degree of consensus is sufficient to merit the label of an Ontario Economic Council Position Paper.

In rendering our assessment of the implications of a continuation of the existing deficit trends, we are, of course, directing our attention in large measure to the implications for medium- and long-term fiscal integrity. However, we believe that we have also approached the deficit issue from the perspective of society's underlying economic and social goals, namely economic growth with high employment, price stability, and an equitable distribution of income.

Our overall assessment is straightforward: the existing fiscal framework at the federal level is unacceptable and unsustainable. It is unsustainable because a continuation of current policies will, over the medium term, lead to a situation where the debt-servicing burden will create a fiscal straight-jacket; unsustainable because the resulting debt and deficit overhang will eventually lead to an expectation that the deficit will be monetized, which in turn will ratchet debt-servicing charges yet higher as these inflationary premia come to be

incorporated in nominal interest rates; unacceptable because we will be loading a substantial debt-servicing burden onto the shoulders of the next generation while at the same time leaving behind a diminished capital stock due to deficit-induced crowding-out of investment; unsustainable also because our fiscal stance is likely to become increasingly off side vis-à-vis fiscal developments south of the border.

Now to some details reflecting the analysis in the position paper.

The sobering message with respect to the fiscal framework is that the budgetary deficit is now running at more than 50 per cent of budgetary revenues. Indeed, the interest charges on the outstanding debt by themselves now amount to over 30 per cent of revenues, and this debt-servicing ratio is destined to rise much higher unless there is a significant shift in the fiscal stance. The latest projections indicate that under the existing fiscal stance federal deficits will remain in the $30 billion-plus area until 1990. And these projections do *not* make allowance for any significant downturn in economic activity over the second half of this decade.

However, the Council recognizes that there may be some problems with focusing solely on published deficit measures. For example, they take into account neither the effect of the business cycle on government revenues and expenditures nor the fact that inflation reduces the real value of the outstanding debt. Omitting these factors in the recent time frame works to overstate the deficit. Thus, proponents of cyclical adjustment and/or inflation adjustment point out that focusing on actual deficits can be misleading and may trigger more drastic actions than are necessary. We accept this argument. On the other hand, there are further adjustments that can be made to the published deficit figures which work in the other direction. For example, the $100 billion of contingent liabilities of the Canada and Quebec Pension

Plan (CPP/QPP) systems are not reflected in the deficit or debt figures. In this regard, it is appropriate to note that although the expected tripling of the CPP/QPP contribution rates in order to put the public-pension system on a pay-as-you-go basis represents a substantial tax increase, this will make no dent on the existing deficit gap, since it is directed to a revenue shortfall that is not reflected in the published deficit figures. Overall, therefore, it is far from clear that the actual deficit figures present an exaggerated picture of the serious nature of the present fiscal stance.

The Council also recognizes that the US deficit probably has a greater influence than our own on the currently high level of real interest rates in Canada and that the Canadian economy would benefit substantially if the Americans cut their deficit. However, it is important to note that in terms of our fiscal positions, the Canadian deficit and debt situation is probably the more serious. In proportion to GNP, our federal deficit is double that in the US. Moreover, the US states are currently running a surplus of some $50 billion-plus, whereas the provincial budgets are in a deficit position in the $10 billion range. And in terms of initial conditions (1982), our debt servicing as a proportion of revenues was one-and-a-half times that for the US. While it is true that our higher level of domestic savings represents an important offset in terms of the implications for investment crowding-out, it is nonetheless the case that in terms of the fiscal stance itself, the situation in Canada is more serious than that in the US.

Where is our concern for unemployment in all of this? Some might argue that it is absent. We do not believe this to be the case. It is true that a larger deficit will imply some increase in consumer demand. However, there are offsetting factors. First, to continue with the existing fiscal structure will undermine confidence and weaken the economy on the productivity and employment-creation fronts.

Second, to the extent that fiscal policy will contribute to employment creation one can argue that the appropriate objective here is to move the overall fiscal thrust away from a consumption-encouraging stance and toward an investment- or employment-augmenting one. In our view, this will do more for job creation than will running up the deficit under the existing fiscal structure. Third, it is too narrow a conception of the unemployment issue to focus only on the benefits from enhancing domestic demand. The real employment push on the demand side will come from being able to penetrate foreign markets. In this regard a move toward fiscal integrity will enhance the likelihood that Canadians and foreigners alike will find in Canada an environment conducive to launching these enterprises. Finally, if job creation and economic activity were solely a function of running up the deficit, then it is Canada and not the United States that should be in the midst of a brisk recovery.

In summary, therefore, we are of the opinion that a do-nothing approach to deficits is far too risky a policy to follow. These risks run the gamut from crowding-out to enhanced foreign indebtedness to a reduction in the capital stock to an increased expectation of future debt monetization and inflation and, above all, to a fiscal situation characterized by a surging debt-servicing burden which may become dynamically unstable if the system is hit by some adverse shock.

We recognize that the task of deficit-trimming will constitute a formidable challenge to the new federal government. However difficult such a task may be now, the mathematics and economics of rapidly rising ratios of debt to GNP ensure such decisions will be substantially more difficult in the future, if indeed there will be any decision flexibility. On this issue there is general agreement. Where agreement is lacking, however, is in terms of the policy response that is required. One group of Council members recommends a new multi-year fiscal

plan – one which retains flexibility to deal with surprises but which firmly tightens policy over time and restores fiscal integrity. Another group feels that more dramatic action is called for immediately.

All of us can and do hope for rapid real growth, continued low inflation, and a return to lower interest rates. Each of these would lessen the concerns associated with the current fiscal stance. However, it is not prudent to bank on a string of continued good luck. In order that Canada maintain sufficient flexibility on the fiscal side in the future, it is of utmost importance that our nation embark now on a plan to restore fiscal integrity.

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Deficits: How Big and How Bad? An Ontario Economic Council Position Paper
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